IN THE HIGH COURT OF GUJARAT AT AHMEDABAD

INCOME TAX REFERENCE No 22 of 1986

For Approval and Signature:

Hon'ble MR.JUSTICE A.R.DAVE Sd/-
and
Hon'ble MR.JUSTICE D.A.MEHTA Sd/-

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1. Whether Reporters of Local Papers may be allowed to see the judgements? : YES

2. To be referred to the Reporter or not? : YES

3. Whether Their Lordships wish to see the fair copy of the judgement? : NO

4. Whether this case involves a substantial question of law as to the interpretation of the Constitution of India, 1950 of any Order made thereunder? : NO

5. Whether it is to be circulated to the Civil Judge? : NO

M/S. NATIONAL WIRE MFG CO

Versus

COMMISSIONER OF INCOME-TAX

Appearance:
MR JP SHAH for Appellant
MR B.B.NAYAK FOR MR MANISH R BHATT
for Respondent No. 1

CORAM : MR.JUSTICE A.R.DAVE
and
MR.JUSTICE D.A.MEHTA

Date of decision: 19/07/2001

CAV. JUDGEMENT

(Per : MR.JUSTICE D.A.MEHTA)

1 The Income Tax Appellate Tribunal, Ahmedabad Bench "B" has referred the following common question for two assessment years.

"Whether, on the facts and in the circumstances of the case, the Tribunal was right in law in holding that the remuneration paid to two individual partners was disallowable u/s.40(b) even though they were partners as a karta of their respective HUFs.?"

The assessment years are 1980-81 and 1981-82, the respective accounting periods being calendar years 1979 and 1980 respectively. The applicant assessee is a registered firm consisting of the following three partners :

(1) Shri K.J.Patel.
(2) Shri Natvarlal Patel (HUF).
(3) Shri Rajnikant Patel (HUF).

Shri Natvarlal and Shri Rajnikant were partners in their representative capacity in as much as they represented the interest of their respective Hindu Undivided Family (HUF) in the said firm. Both Shri Natvarlal and Shri Rajnikant were paid salary of Rs.15,000/- per annum. For each of the assessment years the assessee firm thus claimed a deduction of Rs.30,000/- from its taxable income. The Income Tax Officer disallowed the said claim on the ground that day to day management of business did not require any special skill or labour and further that as per provisions of the Indian Partnership Act, the partners were obliged to work for the firm unless they were specifically taken as dormant partners. The Income Tax Officer thus disallowed the amount of Rs.30,000/- for each of the years under Reference by invoking section 40(b) of the Income Tax Act,1961 (hereinafter referred to as 'the Act').

2. The Commissioner of Income Tax (Appeals) held that Shri Natvarlal and Shri Rajnikant are not partners of the assessee firm in their individual capacity and that both of them possess necessary knowledge and skill for running cinema hall (which was the business carried on by the firm), and thus the payment made to them in their individual capacity could not be disallowed u/s.40(b) of the Act. It was further held by C.I.T.(Appeals) that there was no nexus between the services rendered by the said two partners and the employment of funds of the HUF. The appeal on this ground was therefore allowed. The Revenue went in appeal

before the Tribunal and the Tribunal for the reasons stated in its order dated 16/7/1985 reversed the appellate order and restored the order made by the Income Tax Officer disallowing the impugned payment u/s.40(b) of the Act. It is against this order of the Tribunal that the applicant assessee sought Reference and the aforestated question has been referred to this Court.

3. Mr.J.P.Shah, learned Advocate for the applicant assessee stated that the assessee firm runs cinema hall situated at Naroda and personal attention of a responsible person was highly essential. Accordingly, the partners after mutual consultation entered into an agreement to remunerate Shri Natvarlal and Shri Rajnikant, who were utilising their personal skill and knowledge of running cinema halls and such remuneration was to be paid to them in their individual capacity and not in the representative capacity. It was further contended that the salary was paid to the two persons as being necessary wholly and exclusively for the purpose of the business of assessee and that there was no nexus between the services rendered by those two persons and the investment of funds of the respective Hindu Undivided Family of which those two persons were representatives in the partnership firm.

4. The controversy which we are called upon to decide is no longer res integra. However, great emphasis was laid by Mr.J.P.Shah, learned Advocate on three decisions of the Hon'ble Supreme Court in the case of -

(i) Brij Mohan Das Laxman Das Vs. Commissioner of Income-tax, 223 I.T.R.825,

(ii) Suwalal Anandilal Jain Vs. Commissioner of Income-tax, 224 I.T.R. 754,

(iii) Commissioner of Income-tax Vs. Kanji Shivji and Co., 242 I.T.R. 124,

to contend that when the capacity in which a person is a partner in a partnership firm and the capacity in which such a person receives payment from such a partnership firm is different then provisions of section 40(b) of the Act do not apply. It was further contended that if the decision rendered by the Supreme Court in the case of Rasik Lal and Co. Vs. Commissioner of Income-tax, 229 I.T.R.458, could be said to hold a contrary view a question would arise as to which decision is preferable when the decisions holding conflicting views are rendered by the Supreme Court. It was the submission of Mr.Shah

that dual capacity of a person was judicially recognised and that too by the Supreme Court in the context of applicability or otherwise of provisions of section 40(b) of the Act. It was submitted that once this legal position was accepted it was not possible to take any other view in the matter while deciding the question with which this Court is required to deal with. Apart from the aforesaid decisions of the Apex Court, a decision of the Full Bench of this Court was referred to and relied upon by the learned Advocate for the assessee. He referred to the decision in the case of Chhotalal & Co. vs. Commissioner of Income-tax, Gujarat, 150 I.T.R.276. Mr.Shah read extensively from observations at page 285 of the said decision which are to the following effect :

"The Revenue is not precluded from looking into the real character of the partner and the capacity in which he represents himself in the partnership firm. If that be so, for the purpose of s.40(b) the I.T.Act, 1961, is the Revenue to take note of the representative character of the assessee and make disallowance falling within the section in accordance therewith ? That is the question which we are really called upon to answer here.

What is said for the Revenue is that while the Revenue may take note of the fact that Shri C.S.Virani really represents a HUF when it makes the individual assessment on the HUF of which he is a representative, that will have no bearing when the Revenue seeks to assess the firm to its tax. At the stage, it is said , the real character of Shri C.S.Virani does not call for consideration and he need be treated only as a partner and if so treated, whatever is paid as interest to Shri C.S.Virani irrespective of the character in which such payment is made is to be disallowed on account of s.40(b) of the Act. This approach would assume that, so far as the Revenue is concerned, the Revenue cannot take note of the capacity in which a person happens to be a partner of a firm. Such an approach is unsustainable in law, for whatever may be the obligations as between the partners, arising out of a contract, so far as the Revenue is concerned, it is the real character of the partner who is assessed that would be relevant for assessment purpose. If Shri C.S.Virani is a partner as representing a HUF, at all times the Revenue can only treat him as representing the

HUF, whatever may be the rights of the other partners in the firm as against him. If so, when Shri C.S.Virani as representing the HUF has advanced funds of the HUF to the firm and interest thereon is paid to the HUF, it is interest paid to Shri C.S.Virani, the partner. If he advances amounts from his individual account when he is a partner as representative only of the HUF, the interest is not paid to him qua partner but as a stranger.

We should point out an anomaly if a different view is taken. Supposing a stranger advances a substantial sum of money to a firm on interest and the interest is being paid by the firm to that stranger, such interest payments could be deductible as revenue expenditure under s.37. If by some fortuitous circumstance, such stranger becomes a trustee of a trust, the previous trustee of which was a partner of that firm, can it, for that reason, be said that the interest which had to be paid to him as was done earlier, not as trustee but on his own individual account, should no longer be an item of expenditure to be deducted ? We see neither reason nor logic in such an approach. If the income-tax authorities are to act on the basis of real facts and not on any assumptions, then, for the purpose of s.40(b) they will have to consider the HUF as represented by Shri C.S.Virani as the partner and if that is so, what is paid to Shri C.S.Virani as representing HUF by way of interest will alone fall within the section."

5. Mr.Nayak, learned Advocate for Revenue submitted that the decisions referred to and relied upon by Mr.Shah for the assessee pertained to payment of interest, and hence, are not applicable to the case where the payment was of salary. He referred to and relied upon the Apex Court decision in the case of Rasiklal and Co. (Supra) and submitted that the said decision gives complete answer and urged that the Tribunal's order should not be disturbed.

6. As stated hereinbefore, the question referred to us is no longer res integra and it would not have been necessary for us to deal with the matter in detail but for the decisions of the Apex Court, on which a great stress was laid on behalf of the assessee to contend that the controversy should be decided in favour of the

assessee on the basis of ratio laid down in those decisions. The provisions of section 40(b) of the Act read as under :

"Amounts not deductible - Notwithstanding anything to the contrary in section 30 to 38, the following amounts shall not be deducted in computing the income chargeable under the head 'Profits and gains of business or profession..."

"(b) in the case of any firm, any payment of interest, salary, bonus, commission or remuneration made by the firm to any partner of the firm".

7. Thus, it can be seen that section 40(b) prescribes that any payment of the nature described in the said section made by a firm to any of the partners would not be deductible while computing profits and gains of the firm eventhough such expenditure may otherwise be permissible deduction as per provisions of sections 30 to 38 of the Act in view of the non obstante clause with which the section commences. This Court in the case of Commissioner of Income-tax vs. Yoganand Textiles, 202 I.T.R.869 stated thus :-

"Section 10(4)(b) of the Indian Income-tax Act,1922, which corresponds to the provisions of section 40(b) of the said Act was introduced by the Amendment Act of 1939. Until then, it appears that the State of the law on the subject was far from satisfactory because the decision in each particular case in respect of payments made by way of interest, salary, commission or remuneration by a firm to a partner turned upon determining as a fact whether the payment was to a partner as a partner or in a different character and whether the payment was real and bona fide or only intended to serve as a device to escape taxation. It appears that, with the object of obviating such uncertainly in the determination of the nature of such payments, section 10(4)(b) was introduced by the Amendment Act of 1939. From the wordings of the provisions of section 40(b), it appears to us that any payment of the nature described made by the firm to any of the partners of the firm would not be deductible. The word "any" is a word of wide import and should be given its full meaning in the context of the provision. It will be seen

that there is no indication whatsoever to differentiate between the nature of remuneration or between the purpose for which remuneration was given to any partner. As the provision reads, it seems to us that it imposes an absolute embargo against deductions in respect of any of the payments made by the firm, of the nature enumerated, to any partner of the firm. Explanation 2 which has been added clarifies that interest paid by the firm to an individual who is a partner in a firm in a representative capacity shall not be taken into account for the purpose of the said clause. The wording of the provisions of section 40(b) clearly indicates that they are intended to cover all the payments of the nature described to a partner of the firm by the firm and do not indicate that only such payments as are made to a partner in his capacity as a partner and not other payments made to such partner are covered by the said provision. There is nothing in the said provision to indicate that any category of salary, remuneration, etc.,though paid by a firm to a person who is a partner were to fall outside the scope of the above provision.

The provisions of sections 12 and 13 of the Indian Partnership Act which deal with relations of partners to one another, inter alia, provide that subject to contract between the partners, each partner is bound to attend diligently to his duties in the conduct of the business and a partner is not entitled to receive remuneration for taking part in the conduct of the business. A partner cannot be an employee of the firm. Any monies obtained by a partner as salary are in the nature of profits accrued to him (S. Magnus v. CIT [1958] 33 ITR 538 : AIR 1958 Bom 467). Even a managing partner would stand on the same footing as any other partner and cannot charge the co-partners with any sum in shape of salary or commission. (See Indian Partnership Act by Pollock and Mulla, Fifth edition, at page 47). It appears to us that section 40(b), on its plain reading, does not envisage splitting of capacities of a partner in which he can work and does not warrant a distinction between a partner obliged to work and the one not obliged to work under the terms of a contract or the provision of law. Such a distinction or trend does not follow from the decisions rendered in cases in which

persons were partners not in their individual capacity but in their representative capacity as in the case of "karta" or a "trustee".

Therefore, so far as this Court is concerned the controversy stands concluded.

8. However, it was contended on behalf of the assessee that when provisions of section 40(b) referred to different items viz. interest, salary, bonus, commission or remuneration and the said terms are preceded by the phrase 'any payment' it was not open for the Revenue to take a stand that a different view should be taken in relation to the different items. We may, therefore, take into consideration the meanings as understood legally of the terms 'salary`, 'commission` and 'remuneration`. Black's Law Dictionary has defined the said terms as under :

Commission.Compensation. The recompense, compensation or reward of an agent, salesman, executor, trustee, receiver, factor, broker, or bailee, when the same is calculated as a percentage on the amount of his transactions or on the profit to the principal. Weiner v. Swales, 217 Md.123, 141 A.2d 749, 750. A fee paid to an agent or employee for transacting a piece of business or performing a service. Fryar c.Currin, App., 280 S.C. 241, 312, S.E. 2d 16, 18. Compensation to an administrator or other fiduciary for the faithful discharge of his duties".

"Remuneration. Payment; reimbursement, Reward; recompense; salary; compensation."

"Salary. A reward or recompense for services performed. In a more limited sense, a fixed periodical compensation paid for services rendered. A stated compensation paid periodically as by the year, month, or other fixed period, in contrast to wages which are normally based on an hourly rate".

8.1. Thus, all the three terms carry the same basic meaning i.e. to compensate or reward a person for the services rendered. The question that would then arise is : what is the distinction when employment of funds is compensated by payment of interest and compensation as

aforesaid vis-a-vis services rendered.

9. Under the Income Tax Act, "firm" "partner" and "partnership" have been given the same meaning as assigned to them in the Partnership Act. But the expression "partner" has been extended to include any person who, being minor, has been admitted to the benefits of a partnership. For the assessment years with which we are dealing the scheme of registration of firm would also throw light on the controversy. Section 184 of the Act specifically provides that :(i) the partnership must be evidenced by the instrument in writing, (ii) Individual shares of partnership must be specified in that instrument and (iii) application for registration shall be signed by all the partners. Thus, it can be stated that when individual shares of partners have to be specified, such partners have to sign deed as also application for registration, it would go to show that even if a person joins the partnership in a representative capacity within the firm the position of such a person is that as an individual only.

10. Considering the matter from another angle viz. what would be the position of a person belonging to a Hindu Undivided Family, if he joins a partnership firm on behalf of the family ? what would be the incidence in such a situation under the Hindu Law ? Mulla's Hindu Law, Sixteenth edition, states at page 467 thus :

> "Not all members of the joint family, but only such of its members as have, in fact, entered into partnership with the stranger, become partners. The manager, no doubt, is accountable to the family, but the partnership is exclusively one between the contracting members including the manager and the stranger. Such a partnership would be governed by the provisions of the Indian Partnership Act,1932, with the result that if the manager died, the partnership would be dissolved on his death".

11. It is well settled that the firm has no distinct legal entity apart from the partners constituting it and although in Income-tax Law a firm is a unit of assessment and has certain attributes of personality, the business carried on by the firm is in the eye of law the business carried on by the partners collectively; the profits of the partnership firm are the profits earned by the partners, whichever may be the mode or form in which they reach them; the firm as such has no separate rights in the partnership assets, but they are properties in which

all the partners have joint or common interest. A Hindu Undivided Family directly or indirectly cannot become a partner of the firm because the firm is an association of the individuals.

12. In the case of Commissioner of Income Tax Vs. R.M.Chidambaram Pillai, 106 I.T.R. 292, it is laid down as follows :

"A firm is not a legal person even though it has some attributes of personality. In Income-tax a firm is a unit of assessment, by special provisions, but is not a full person, since a contract of employment requires two distinct persons, viz. the employer and the employee, there cannot be a contract of service, in strict law, between a firm and one of its partners. Payment of salary to a partner represents a special share of the profits. Salary paid to a partner retains the same character of the income of the firm."

xxx xxx xxx

"The Scheme of the Act, eyeing it with special reference to sections 10(4)(b) and 16(1)(b), designates employee's salary as profit, where the servant is none other than a partner i.e. co-owner of the business. If such be the rationale of the relevant provisions, the key to the solution of the problem is within easy reach.

Salaries are profits known by a different name and must be treated as such for taxation purposes."

13. In the case of Rasiklal & Co.,(Supra), the Apex Court has stated that the Hindu Undivided Family cannot be in a better position than a firm in the scheme of the Partnership Act. Referring to and relying upon one of the earliest decisions of this Court in the case of Dulichand Laxminarayan Vs. Commissioner of Income Tax, 29 I.T.R. 535, it was stated that the reasons stated in the case of Dulichand (Supra), i.e. if firm cannot join the partnership with another individual on similar lines a Hindu Undivided Family also cannot join a partnership with another individual. It is further stated that a Hindu Undivided Family being a fluctuating body of individuals can not enter into a partnership with other individual partners. It cannot do indirectly what it cannot do directly. If karta or any other member of a

Hindu undivided family joins a partnership, he can do so only as an individual. His rights and obligations vis-a-vis other partners are determined by the Partnership Act and not by Hindu law. Such a person shall be a nominee of Hindu Undivided Family and in so far as the other partners of the firm are concerned they would enter into a contract only with the Nominee. In the case of any claim arising against firm or its partners an outsider can only make that claim against such partners and not against the Hindu Undivided Family. Hindu Undivided Family not being a 'person' cannot enter into an agreement of partnership. The Apex Court has thereafter referred to various provisions of Partnership Act and while dealing section 13 of the Partnership Act, it is stated thus :

> "The specific provision in section 13 of the Partnership Act that a partner is not entitled to receive any remuneration for taking part in the conduct of the business has been interpreted to mean that every partner is bound to attend diligently to the business of the firm. For doing his duties, he cannot charge his copartners any sum or remuneration whether in the shape of salary , commission or otherwise on account of the trouble taken by him in conducting the partnership business. There, however, can be a special contract to the contrary in which case, the provisions of that contract will prevail.
>
> Section 40(b) of the Income-tax Act will apply even when there is such a special contract. Any commission paid by a firm to its partner will not be permitted as deduction from the business income of the firm. If a claim is made by a partner that he is representing a Hindu undivided family or any other body of person then the position in law will not be any different. The Hindu undivided family is not and cannot be a partner in a partnership firm. The remuneration or the commission that is paid to the partner cannot be claimed to be a remuneration or commission paid to the Hindu undivided family. The partner may be accountable to the family for the monies received by him from the partnership. But in the assessment of the firm, the partner cannot be heard to say that he has not received the commission as a partner of the firm but in a different capacity."

14. In sofar as the interest is concerned the same would stand on a different footing in view of the fact that it is possible to trace the source of the funds. Therefore, the aspect of a partner having dual capacity i.e. one as a partner in a partnership firm and the other qua the interest of the person who is represented by such partner is recognised, because the question that could be posed and answered : interest is paid on which funds and who has invested those funds?

15. Reliance placed on the Full Bench judgment in the case of Chhotalal & Co. (Supra), on behalf of the assessee cannot carry the case of the assessee any further in light of what has been stated by the Court at page 288. The Full Bench speaking through His Lordship P.S.Poti, C.J. stated :

> "We are not proposing to go into the decisions concerning payment of salary to a partner, for such payment stands on a footing different from the payment of interest. Payment of interest on amounts lent to the firm can be traced either to the individual or to the representative body by tracing the nature of the funds advanced, but not so labour by a partner. Whether he works in the firm and receives salary as an individual or as a representative of the family cannot be known from the way he functions and, therefore, payment of salary must stand on a different footing".

16. Now so far as the decisions in the cases of Brijmohan Das Laxmandas and Suwalal Anandilal Jain (Supra) are concerned, in both the decisions the Apex Court has decided the controversy primarily keeping in view Explanation 2 and holding the same to be clarificatory in nature. Moreover, as stated by the Full Bench of this Court a case of payment of interest would stand on a different footing from that of payment of the other items enumerated in section 40(b) of the Act as interest has direct nexus with the funds employed.

17. Mr.Shah vehemently contended that the decision rendered in the case of Rasiklal & Co. (Supra) cannot be held to be good law or should be confined to the facts of that case only, in light of the subsequent pronouncements by three Judges Bench in the case of C.I.T. Vs. Kanji Shivji & Co.(Supra) wherein it was held that " the conclusion of this Court in the earlier cases of Brij Mohan Das Laxman Das [1997]223 ITR 825 and Suwalal Anandilal Jain [1997] 224 ITR 753 still represents the

correct exposition of the law..."

18. The Apex Court in the case of C.I.T. Vs. Sun Engineering Works Pvt.Ltd.,198 I.T.R.297, has cautioned against reading its own judgment in a truncated manner. It is stated :

"It is neither desirable nor permissible to pick out a word or a sentence from the judgment of this Court, divorced from the context of the question under consideration and treat it to be the complete "law" declared by this Court. The judgment must be read as a whole and the observations from the judgment have to be considered in the light of the questions which were before this Court. A decision of this Court takes its colour from the questions involved in the case in which it is rendered and, while applying the decision to a later case, the Courts must carefully try to ascertain the true principle laid down by the decision of this Court and not to pick out words or sentences from the judgment, divorced from the context of the questions under consideration by this Court, to support their reasonings. In Madhav Rao Jivaji Rao Scindia Bahadur v. Union of India [1971] 3 SCR 9 ; AIR 1971 SC 530, this Court cautioned (at page 578 of AIR 1971 SC) :

It is not proper to regard a word, a clause or a sentence occurring in a judgment of the Supreme Court, divorced from its context, as containing a full exposition of the law on a question when the question did not even fall to be answered in that judgment."

19. Therefore, adopting the approach enunciated by the decision of Sun Engineering Works (Supra) it can be stated that the aforesaid conclusion in the case of Kanji Shivji & Co. (Supra) has to be read in the context of what is stated just prior thereto by the Apex Court when it held " In other words, the application of section 40(b) and the said Explanation was not really in issue in Rasik Lal's case [1998] 229 ITR 458 (SC). The observations in Rasik Lal's case [1998] 229 ITR 458 (SC) relating to the said Explanation must, therefore, be treated as obiter dicta. Therefore, the entire line of case law commencing from the case of Brij Mohan Das Laxman Das and ending with the case of Kanji Shivji & Co. shall hold the field as and when the question regarding

payment of interest and its allowability or otherwise u/s. 40(b) of the Act arise in case of assessment of partnership firm. The Apex Court itself is aware that the payment of salary, commission or remuneration shall stand on a different footing and that is why the aforesaid observations both in the case of Rasiklal & Co.(Supra) and Kanji Shivji & Co.(Supra).

20. While dealing with the earlier two decisions in the case of Brij Mohan Das Laxman Das (Supra) and Suwalal Anandilal Jain (Supra), it was observed by the Supreme Court in Rasiklal's case (Supra) that the said decisions would stand on different footing because the Court was not called upon to determine any question of payment of interest. It was stated as under :

> "However, in the case before us, no question of payment of any interest is involved. A commission was paid by the firm for the services rendered by the partner. Such commission cannot be paid because of the provisions of section 13 of the Partnership Act in the absence of a special contract. Even if a special contract exists, section 40(b) of the Income-tax Act prohibits allowance of such commission as deduction from the business income of the firm."

21. In view of what is stated hereinbefore it is apparent that there is no conflict between the decision relating to interest on the one hand and decisions dealing with payment of salary, remuneration or commission on the other hand. Therefore, it is not necessary for us to deal with the case law referred to by Mr.Shah, learned Advocate, for the purpose of deciding as to which precedent has to be given preference. In our view, the controversy is fully concluded by the decision of this Court in the case of C.I.T. Vs. Yoganand Textiles (Supra) and the Apex Court in the case of Rasiklal & Co. Vs. C.I.T.(Supra). We, therefore, hold that the Tribunal was justified in law in holding that the remuneration in the form of salary paid to two individuals was disallowable u/s.40(b) of the Act, eventhough they were partners as being karta of their respective HUF in the partnership firm.

22. The question referred to us is therefore answered in the affirmative i.e. against the assessee and in favour of the revenue. The Reference stands disposed of accordingly with no order as to costs.

Sd/- Sd/-
(A.R.Dave, J) (D.A.Mehta,J)

m.m.bhatt